

CFTC Exemptions for Non-US Fund Managers Transacting in US Derivatives Markets

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The US derivatives markets are renowned for their depth and innovation, drawing participants from across the globe. These markets have a long-established history of trading futures contracts on US Treasury securities, US and non-US stock indexes, and physical commodities, as well as listed options on these instruments. In recent years, new types of contracts based on novel asset classes and indices have emerged. Examples of these new asset classes include cryptocurrencies, volatility, environmental attributes, and macroeconomic indicators. In addition to listed contracts, over-the-counter (OTC) derivatives may be executed bilaterally and either submitted for clearing or maintained as bilateral transactions if they are not subject to mandatory clearing requirements.

Background

For non-US fund managers, participation in these markets involves assessing and navigating an additional layer of regulation imposed by the Commodity Futures Trading Commission (CFTC) and, in some cases, the Securities and Exchange Commission (SEC). The jurisdictional boundaries between these two regulatory regimes can be complex and unclear, with CFTC jurisdiction under the Commodity Exchange Act (CEA) extending beyond physical commodities to derivatives on many types of financial instruments and indices.¹ Economically similar instruments may fall under different regulatory frameworks. For instance, futures or cash-settled swaps on bitcoin, as well as options on bitcoin, fall under the CFTC's jurisdiction, whereas options on exchange-traded funds (ETFs) designed to track bitcoin generally fall under the SEC's jurisdiction.

This bulletin does not aim to provide a comprehensive overview of the applicable regulations. Instead, it focuses on a specific regulatory challenge that non-US fund managers may encounter: the potential requirement to register with the CFTC as a commodity pool operator (CPO). It also discusses certain exemptions that may be available to avoid this registration requirement.

While it may be intuitive that submitting orders for execution on a US exchange subjects market participants to regulations governing those activities—such as rules against manipulation, deceptive or disruptive trading practices, position limits, and exchange-specific requirements—it may be less apparent that non-US fund managers could become subject to registration and regulation as CPOs under the CEA. The CPO regulatory regime primarily addresses the solicitation and communication with prospective and current fund investors,² making its reach beyond US borders seem counterintuitive to many non-US managers when the investment fund is offered only to non-US investors and the US activity, *i.e.*, trading, is distinct from the solicitation of investors.

However, the CEA does not provide clear criteria for determining when the CFTC has regulatory jurisdiction over non-US persons and activities, creating uncertainty and risk for non-US fund managers. The relevant jurisdictional standards assess whether activities within the United States fall within the “focus” of a particular statute or, in the case of swap-related provisions enacted by the Dodd-Frank Act, whether activities outside the United States have a direct and significant connection with activities in, or an effect on, US commerce.³ However, given the limited clarity offered by existing case law and regulatory guidance, non-US fund managers may seek to rely on exemptions from CPO registration to avoid or minimize regulatory uncertainty.

The CFTC has adopted two rules that provide exemptions from CPO registration for offshore CPOs: CFTC Rule 3.10(c)(5) and CFTC Rule 30.4(c).⁴ These exemptions may offer relief from the CPO registration requirements, provided that certain conditions are met. We discuss the conditions for these exemptions below. Non-US fund managers considering participation in US derivatives markets or marketing to US investors should carefully evaluate

these exemptions, as well as other applicable regulatory requirements, and seek appropriate legal counsel to ensure compliance.

CFTC Rule 3.10(c)(5) – Exemption for Non-US CPOs

The CFTC has a “longstanding policy of focusing its customer protection activities upon domestic firms, and upon firms soliciting or accepting orders from domestic participants.”⁵ Accordingly, CFTC Rule 3.10(c)(5) (3.10 Exemption) provides that a “foreign located person”⁶ acting as a CPO (non-US CPO) in connection with a “covered transaction”⁷ need not register with the CFTC as a CPO when the covered transaction is executed on behalf of a commodity pool comprised of participants who are “foreign located persons” or “international financial institutions”⁸ (No US Participant Requirement). However, any such covered transaction that is required or intended to be cleared on a registered derivatives clearing organization (DCO) must be submitted for clearing through a registered futures commission merchant (FCM), unless the commodity pool that is party to the covered transaction is a clearing member of such DCO.

Initial Capital Contributions by Affiliate Permitted

With respect to the No US Participant Requirement, initial capital contribution to a commodity pool by a person that directly or indirectly through one or more persons, controls, is controlled by, or is under common control with the non-US CPO (Affiliate) is not considered for purposes of determining whether the commodity pool operated by the non-US CPO meets the No US Participant Requirement. However, the following conditions must also be met: (i) the Affiliate is not a natural person; (ii) the Affiliate and its principals are not barred or suspended from participating in commodity interest markets in the United States, its territories or possessions; and (iii) interests in the Affiliate are not marketed as providing access to trading in commodity interest markets in the United States, its territories or possessions.

Inadvertent US Participants Not Disqualifying

The CFTC designed the 3.10 Exemption to allow reliance by a non-US CPO that has taken reasonable steps to minimize the likelihood that participation units in the operated offshore pool are offered or sold to persons located in the United States. Therefore, a commodity pool operated by a non-US CPO will be considered in compliance with the No US Participant Requirement if: (i) the commodity pool is organized and operated outside of the United States, its territories or possessions; (ii) the commodity pool's offering materials and any underwriting or distribution agreements include clear, written prohibitions on the commodity pool's offering to participants located in the United States and on US ownership of the commodity pool's participation units; (iii) the commodity pool's constitutional documents and offering materials (A) are reasonably designed to preclude persons located in the United States from participating therein; and (B) include mechanisms reasonably designed to enable its operator to exclude any persons located in the United States that attempt to participate in the offshore pool, notwithstanding those prohibitions; (iv) the non-US CPO exclusively uses non-US intermediaries for the distribution of participations in the commodity pool; (v) the non-US CPO uses reasonable investor due diligence methods at the time of sale to preclude persons located in the United States from participating in the commodity pool; and (vi) the commodity pool's participation units are directed and distributed to participants outside the United States, including by means of listing and trading such units on secondary markets organized and operated outside of the United States, and in which the non-US CPO has reasonably determined participation by persons located in the United States is unlikely.

Reliance on Exemption Permitted on a Pool-by-Pool Basis

A non-US CPO can rely on the 3.10 Exemption on a pool-by-pool basis. This means the non-US CPO can use the exemption for its offshore pools while simultaneously relying on other exemptions or CPO registration for pools offered to US participants.⁹ In permitting reliance on the 3.10 Exemption on a pool-by-pool basis, the CFTC stated that it would appropriately focus its oversight on those pools that solicit and/or accept persons located in the United States as pool participants.¹⁰ The CFTC also noted (i) the increasing globalization of the commodity pool industry, and observing that several of the largest CPOs at the time of the 2020 Release were located outside the United States; and (ii) that these larger CPOs typically operate many different commodity pools simultaneously, including some pools for US investors and other pools for non-US persons.¹¹

No Independent Clearing Requirement

The 3.10 Exemption is not limited to cleared transactions. Specifically, as noted above, the 3.10 Exemption applies to any “covered transaction” engaged in by a non-US CPO. A “covered transaction” is defined to mean a commodity interest transaction executed bilaterally or made on or subject to the rules of any DCO or registered swap execution facility. The 2020 Release clarifies that while not all commodity interest transactions are subject to a clearing requirement under the CEA or CFTC regulations, or even available for clearing by a DCO, those transactions that are required to be cleared must be cleared by a clearing member of the relevant DCO.¹² Accordingly, the 3.10 Exemption is also conditioned on (i) clearing on a DCO any commodity interest transaction that is required or intended to be cleared on a registered DCO; and (ii) an additional requirement that such transactions be cleared through a registered FCM, unless the commodity pool is itself a clearing member of the relevant DCO.

Persons Relying on 3.10 Exemption Remain Subject to Antifraud Provisions and CEA Generally

A non-US CPO relying on the 3.10 Exemption remains subject to the antifraud prohibitions in Section 4o of the CEA. Section 4o(1) makes it unlawful for a CPO or any associated person of a CPO to directly or indirectly: (i) employ any devise, scheme, or artifice to defraud any pool participant or prospective pool participant; or (ii) engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any pool participant or prospective pool participant. Section 4o(2) makes it unlawful for any CPO or an associated person of such CPO to represent or imply that such person has been sponsored, recommended, or approved by the CFTC or any US agency. As mentioned previously, an exempt CPO remains subject to rules governing trading on US markets, such as those against manipulation, deceptive or disruptive trading practices, position limits, and exchange-specific requirements.

CFTC Rule 30.4(c) – Exemption for Offshore Exchange Transactions

Part 30 of the CFTC regulations governs the offer and sale of foreign futures and options contracts to customers located in the United States. CFTC Rule 30.4(c) makes it unlawful for any person (whether a US or non-US person), to solicit, accept, or receive funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading, directly or indirectly, in any foreign futures contract or foreign options transaction unless such person is currently registered as a CPO under the CEA and with the CFTC. However, the rule provides an exemption from CPO registration (30.4 Exemption) for any person with respect to any non-US fund provided that: (i) the fund does not transact futures contracts or options on any US futures markets; (ii) the fund is registered under the Investment Company Act of 1940 and its securities are registered in accordance with the Securities Act of 1933, or exempt from such registration requirements; and (iii) no more than 10% of fund assets come from US investors and no more than 10% of fund investors are US investors (10% Restrictions). The 30.4 Exemption is useful only if the fund in question trades commodity interests exclusively on non-US exchanges and only if participation by US investors can be limited to the 10% Restrictions required by the rule.

No Filing Required to Claim 3.10 Exemption or 30.4 Exemption

A non-US CPO's reliance on the 3.10 Exemption or the 30.4 Exemption is self-executing. Accordingly, no filing with the CFTC or the NFA is necessary to claim either exemption. However, such non-US CPO should monitor its compliance with the conditions of the applicable exemption and retain appropriate records to evidence satisfaction of the conditions.

Conclusion

Non-US fund managers engaging in US derivatives markets or offering non-US funds to US investors should be aware of potential CPO registration obligations and the available exemptions. The 3.10 Exemption may offer a flexible and attractive option for non-US fund managers who operate offshore funds with foreign participants and trade in both bilateral and exchange-traded commodity interests. The 30.4 Exemption may be an alternative for fund managers who trade only in foreign futures or options contracts and meet the securities registration and US

participation limits. However, both exemptions have specific conditions and limitations that must be carefully followed and monitored.

More Information

We are available at any time to answer questions, discuss scenarios, and provide guidance. If you would like further information concerning the matters discussed in this article, please contact any of the following attorneys or the Chapman attorney with whom you regularly work:

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- 1 As relevant to this bulletin, the product scope of the CFTC's jurisdiction is embodied in the definition of the term "commodity interest", which is far broader than suggested by the ordinary usage of the term "commodity" to mean agricultural and energy products, metals and other industrial raw materials. As defined in CFTC Rule 1.3, the term "commodity interest" means: any contract for the purchase or sale of a "commodity" for future delivery; any "swap", as defined in the CEA; certain margined or leveraged transactions on foreign currencies or commodities offered to retail investors, as described in section 2(c)(2)(C)(i) or section 2(c)(2)(D)(i) of the CEA; any commodity option authorized under section 4c of the CEA; and any leverage transaction authorized under section 19 of the CEA. The term "swap" generally includes: swaps on interest rates, foreign currencies, physical commodities, broad-based securities indices, US Treasury securities and certain other securities exempted under the federal securities laws; interest rate caps and floors; options on commodities; and options and forwards on foreign currencies (other than certain fixed rate, physically delivered foreign currency forwards and swaps that qualify as exempt and foreign currency options entered in to on a national securities exchange). Commodity futures contracts include futures on stock market indices, economic indices, US Treasury securities and security futures products.
- 2 CFTC Rule 1.3 defines "commodity pool operator", in relevant part, to mean "any person engaged in a business which is of the nature of a commodity pool, investment trust, syndicate, or similar form of enterprise, and who, in connection therewith, solicits, accepts, or receives from others, funds, securities, or property, either directly or through capital contributions, the sale of stock or other forms of securities, or otherwise, for the purpose of trading in commodity interests ...".
- 3 See *Morrison v. National Australia Bank Ltd.*, 561 US 247 (2010); CEA Section 2(i).
- 4 The exemption under CFTC Rule 30.4(c) is restricted to pools where the only commodity interests engaged in are foreign futures and options, and thus the exemption is not likely to be relevant to the scenarios we focus on in this bulletin – non-US fund managers seeking to invest in instruments traded on US markets. However, the conditions of CFTC Rule 30.4(c) regarding US investor participation are less restrictive than those of CFTC Rule 3.10(c)(5), so the exemption may be of interest to non-US fund managers that wish to allow limited US participation in their funds, while restricting commodity interest activities to foreign futures and options.
- 5 Exemption from Registration for Certain Foreign Intermediaries, 85 Fed. Reg. 78718, 78722 (Dec. 7, 2020) ("2020 Release").
- 6 CFTC Rule 3.10(c)(1)(ii) defines "foreign located person" to mean "a person located outside the United States, its territories, or possessions."
- 7 CFTC Rule 3.10(c)(1)(i) defines "covered transaction" to mean "a commodity interest transaction, as defined in § 1.3 of this chapter, executed bilaterally or made on or subject to the rules of any designated contract market or registered swap execution facility."
- 8 CFTC Rule 3.10(c)(1)(iii) defines "international financial institution" to mean "the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, the United Nations, the European Stability Mechanism, the North American Development Bank, those institutions defined as "international financial institutions" in 22 USC. 262r(c)(2), those institutions defined as "multilateral development banks" in Article 1(5(a)) of Regulation (EU) No. 648/2012 of the European Parliament and of the Council on OTC Derivative Transactions, Central Counterparties and Trade Repositories, their agencies and pension plans, and any other similar international organizations, and their agencies and pension plans."
- 9 CFTC Rule 3.10(c)(iv).
- 10 2020 Release at 78724.
- 11 *Id.*
- 12 2020 Release at 78723.

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